What Now? – Part One

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
February 2021
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
Used with permission from the Law Professor Blog Network

Overview

The title of today's article seems to be on the minds of many farmers and ranchers in recent days with the beginning of a new Congress and the inauguration of Joe Biden. I have had many emails, phone calls and conferences with farm families recently that are asking what the impact of tax changes on their businesses and livelihoods might be. Are structural changes in the form of the farming business required? Should existing estate plans be reviewed? What income tax moves should be made? Should capital assets be sold now? These are important questions.

Today's article is Part One of a two-part series on tax changes that might be forthcoming soon and what the changes could mean. Today, I take a look at possible changes in the income tax world. In Part Two, I will examine what might happen on the estate planning side of the equation.

Federal Income Taxation Possible Changes

While there is no definite proposed tax bill(s) yet, and no detailed articulation of possible tax legislation has clearly been offered, there were things that candidate-Biden's people placed on his website before the election.

Increase in the maximum ordinary and capital gain tax rates. It now appears possible that the top individual federal income tax rate on ordinary income (as well as net short-term capital gains) could return to a 39.6 percent rate, up from the present 37 percent rate. Comments were also made that rates on individuals with income (taxable?) above $400,000 would also be increased. If true, then a married couple filing jointly that is presently in the 32 percent bracket could see a rate increase. But, again, it's not clear whether the $400,000 figure is for a married couple filing jointly or for a single person, or whether the threshold refers to gross or taxable income.

Itemized deductions. There are a couple of key possibilities to watch with respect to itemized deductions. Starting in 2018, many itemized deductions were eliminated but, in return, the standard deduction was essentially doubled. For lower-income individuals this represented a major tax break and tax simplification. Now, a new policy may reduce the standard deduction to prior levels with a restoration of itemized deductions (for taxpayers that itemize deductions). The tax benefit of itemized deductions (including charitable deductions and those stemming from a contribution to a pension plan) would appear to be limited to 28 percent for higher-income taxpayers (however that is defined). Thus, a dollar of itemized deduction would only cut the tax bill by $.28. A taxpayer in a tax bracket higher than 28 percent would not see a benefit of an itemized deduction any greater than 28 percent on the dollar.

The so-called "Pease limitation" was repealed for tax years beginning after 2017. It operated as a "stealth" tax on higher-income taxpayers. Before it was repealed, it reduced the value of a taxpayer's itemized deductions by three percent for every dollar of taxable income above a certain threshold – effectively increasing the taxpayer's marginal tax rate. The "buzz" is that the Pease limitation would be put back in place.

As a hat-tip to taxpayers (e.g., voters) in the high-tax states such as California, Illinois and New York, a pre-election policy position indicates that the limit on the deduction for state and local taxes would be removed. This would be a significant benefit for higher income taxpayers.

Capital gains. It is likely that a legislative push will be made to increase the capital gain rates on higher-income individuals. The present top rate on long-term capital gains is 20 percent. Thanks to a provision included in Obamacare (adding I.R.C. §1411) that 20 percent rate jumps to 23.8 percent if the gain is passive for married taxpayers filing jointly with modified adjusted gross income exceeding $250,000 ($200,000 for a single filer). It appears likely that a legislative proposal will include a provision taxing net long-term gains and dividends at the ordinary income rate for taxpayers with income (taxable?) over $1 million. If the gain is passive, the effective rate would jump to a combined 43.4 percent. That would amount to a tax increase of 82.4 percent on such gains.

Observation. Coupled with state-level taxation of capital gains, the effective rate could exceed 50 percent.

If capital gain rates increase, that could create a greater incentive to use charitable remainder trusts (CRT). A CRT is funded by the transfer of property from the donor. There is no tax on the transfer of the property to the CRT. The CRT then sells the property tax-free and uses the proceeds to annually pay the beneficiary (typically the donor) a percentage of the market value of the trust. The annual distribution comes first from the trust's net income and then from principal. The distributions to a non-charitable beneficiary are taxable annually as ordinary income to the extent there is net income to the CRT. The remainder of the distribution is taxable as capital gain to the extent there is accumulated short and long-term capital gain to the CRT calculated using the donor's carryover tax basis. If the distributions to the beneficiary are larger than the net income and accumulated capital gain of the CRT, the difference is not taxable to the beneficiary. If a "net income with make-up provisions" CRT is used, it might be possible to delay distributions to a time (up to 20 years) when capital gain and ordinary tax rates are lower. But, of course, future rates are unknown.

An intentionally non-grantor trust might also be advisable to avoid an increase in the capital gains tax as well as state income tax (except for New York). These trusts are very complex and usually work well for large estates in tandem with the high-level (currently) of the federal estate tax exemption. They became popular after the tax changes that went into effect for tax years beginning after 2017, but could still have merit to avoid a higher capital gains rate and state income tax.

Self-employment tax. Presently, for 2021, an employee pays a combined rate of 7.65 percent for Social Security and Medicare. The OASDI portion is 6.2 percent on earnings up to $142,800. The Medicare portion (hospitalization insurance) is 1.45 percent on all earnings. The rate for self-employed persons is the full combined 15.3 percent up to the $142,800 base. Also, persons with earned income over $200,000 ($250,000 for MFJ) pay an additional 0.9 percent in Medicare taxes due to another provision in included in Obamacare. Thus, for a self-employed person, the rate is 2.9 percent from $142,800 to $200,000 ($250,000 mfj) and then 3.8 percent above those thresholds.

What looks likely to be proposed is that the 12.4 percent OASDI portion would apply to wages and net self-employment income in excess of $400,000. Whether this is in addition to the existing 3.8 percent tax on incomes at this level or would be the total percentage amount is not clear.

Observation. Clearly, if these self-employment tax changes occur, it will incentivize the creation of or conversion of existing entities to S corporations. Doing so will allow some of the earnings to be received in the form of a salary (subject to self-employment tax) with the balance taken as S corporation dividends (not subject to self-employment tax). The salary must approximate "reasonable compensation" (I have written a blog article on that issue in the past), but utilizing an S corporation is a good technique (as a rule of thumb) when at least $10,000 of self-employment tax savings can be achieved over other entity forms (including a

sole proprietorship). One concern, of course, would be if the Congress were to eliminate the self-employment tax savings of an S corporation for businesses that provide personal services.

Credits. One possible proposal is an increase in the child tax credit to $4,000 for a qualifying child ($8,000 for two or more qualifying children). Apparently, the credit would remain refundable and would start phasing out at income levels above $125,000. A new credit (refundable?) could be proposed for certain caregivers.

Eligible first-time homebuyers might receive a refundable tax credit of up to $15,000 upon the purchase of a home. Low-income renters could see a refundable tax credit designed to reduce the cost of rent and associated utilities to no more than 30 percent of monthly income. Such a provision would be a variation of state-level tax credits for tenants of residential properties that exist in about half of the states.

Other credits can be anticipated to benefit less efficient and more costly forms of energy, while simultaneously reducing or eliminating standard business deductions for the oil and gas industry.

Real estate-related activities. What I have seen are discussions about: (1) eliminating the $25,000 deduction for losses related to real estate activities where the taxpayer actively participates in the activity but falls short of material participation (*I.R.C. §469(i)*): (2) eliminating the like-kind exchange rules for real estate trades; slowing down depreciation for certain types of business property; and eliminating the 20 percent qualified business income deduction of I.R.C. §199A for rental real estate activities. Related to this last point, there are rumblings that the I.R.C. §199A deduction could be eliminated in its entirety. For many small businesses, that would amount to a effective tax rate increase ranging between three and five percent.

Convert to a Roth? Should a taxpayer move funds from a traditional IRA to a Roth? The answer, as is the case with many tax-related questions, is that it "depends." If tax rates are expected to be higher in the future, it may make tax-sense to make the conversion and pay the tax on the conversion at what is anticipated to be now-lower rates. But other considerations should be made. What about the impact of state-level taxes? What about the impact of the loss of ability to stretch the payout with respect to certain beneficiaries? Will there be an impact on various ways to offset income with a Roth, such as charitable donations? Will Medicare premiums be impacted? What happens if Social Security benefits have already started to be received? These are some of the considerations that need to be made when considering converting a traditional IRA to a Roth.

Corporate tax. It is likely that a legislative tax proposal will increase the corporate tax rate by 33 percent, from its present 21 percent to 28 percent, and restore the alternative minimum tax on corporations above a threshold of annual income.

Retroactive Tax Increase?

If and when tax changes occur, when will they be effective? Retroactive tax changes create complexity, but can be legal. As for complexity, estimated taxes and withholding are based on the law in existence at the time of payment. If the law changes retroactively, those "pre-paid" taxes now must be recomputed. To be legal, a retroactive tax law change can satisfy the constitutional due process requirement if it is rationally related to a legitimate purpose of government. Given the enormous amount of spending that the Congress engaged in during 2020 to deal with the economic chaos, a "legitimate purpose" could be couched in terms of the "need" to raise revenue. *See, e.g., Pension Benefit Guaranty Corporation v. R.A. Gray & Co., 467 U.S. 717 (1984); United States v. Carlton, 512 U.S. 26 (1994); In re Fifield, No. 04-10867, 2005 Bankr. LEXIS 1210 (Bankr. D. Vt. Jun. 20, 2005).* That's even though historic data indicate that government revenues don't necessarily increase in the long-term from tax increases.

Of course, tax changes that occur on either a retroactive or date of enactment basis make planning impossible.

Conclusion

In Part Two, I will turn my attention to what might happen on the estate planning front.

For more information about this publication and others, visit AgManager.info.
K-State Agricultural Economics | 342 Waters Hall, Manhattan, KS 66506-4011 | 785.532.1504
www.agecononomics.k-state.edu
Copyright 2021: AgManager.info and K-State Department of Agricultural Economics